// EBRI ISSUE BRIEF

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BASIC TAX REFORM: IMPLICATIONS FOR EMPLOYEE BENEFITS

ABSTRACT

Basic tax reform is a popular idea. Members of Congress and President Reagan have endorsed it, along with researchers and opinionmakers across the entire political spectrum. Those who support tax reform, however, should understand that it would not cut taxes. Tax rates can be lowered, and the same amounts of revenue generated, only if current-law tax preferences are cut back or eliminated.

Basic tax reform proposals currently pending in Congress would dramatically change the tax treatment of health, welfare, and "fringe" benefits in the process of restructuring the tax code. Lower- and middle-income workers would be the primary persons affected by such changes. Employer-provided benefits have become an important element of economic security for more than 80 million workers and their dependents.

Few will argue that the current tax structure cannot be improved. Policymakers should not lose sight of the social goals promoted by various tax-code provisions, however. The benefits of a simpler tax code have to be weighed against proposals that would threaten an employment-based income security system that has taken generations to build.

Basic tax reform is in style this election year. In his State of the Union message, President Reagan stated that he has asked the Treasury Secretary "for a plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly." He went on to say that such a plan "could make the tax base broader so personal tax rates could come down, not go up. I have asked that specific recommendations, consistent with those objectives, be presented to me by December 1984." 1/ The National-House Democratic Caucus recently stated that its number one initiative is to replace the present tax code with a "simple, progressive tax with a limited number of rates,"--the so-called Fair Tax Plan. 2/ At least eight basic tax reform proposals have been introduced to date in the 98th Congress. Many researchers and opinion leaders have promoted tax reform as well. Forecasts of continuing high deficits promise to keep this issue alive; it is possible that only fundamental tax reform may generate the amount of revenues necessary to keep both federal deficits and tax rates at manageable levels.

Basic tax reform proposals would lower marginal tax rates and expand the income tax base. The tax base would be expanded by eliminating many current law tax preferences. Among the tax preferences likely to be eliminated or restricted are those that govern the tax treatment of employee benefits. The perceived benefits of a simpler tax system thus have to be weighed against the costs to taxpayers of eliminating certain economic incentives. Nearly 80 million employees and their dependents have built their economic security around employer-provided benefits. All taxpayers--employers and employees--thus have a personal stake in the debate over basic tax reform.

This Issue Brief examines the implications of basic tax reform for employee benefits. It suggests that both policymakers and taxpayers need to examine the social and economic implications of these proposals as well as their impacts on the tax system. The following sections examine:

- the mechanics of basic tax reform;
- the structure of pending legislative proposals and their implications for employee benefits; and
- the implications of basic tax reform for employees' income security.

MECHANICS OF BASIC TAX REFORM

Basic tax reform proposals offer ways to restructure--not lower--the nation's tax bill. Most proposals do not envision widespread tax cuts, but would instead change the distribution of tax liability among individuals. This would be done by expanding the tax base to eliminate many tax preferences in current law.

1/ U.S. Congress, House, Congressional Record, 98th Cong., 2d sess., 25 January 1984, H 143.

2/ U.S. Congress, House, The National-House Democratic Caucus, Renewing America's Promise: A Democratic Blueprint for Our Nation's Future (Washington, D.C.: National-House Democratic Caucus, 1984).

The broader the tax base, the lower the average rate at which income can be taxed to yield the same amount of revenue. As an illustration, consider the three hypothetical tax systems,3/ along with current law, presented in Table 1. Systems 1 through 3 represent alternatives to the current-law tax base,

TABLE 1

A Comparison of Tax Bases and Tax Rates
Under Alternative Tax Systems
(in billions of dollars)

	Total Personal Income a/	Total Taxable Income	Tax Rate b/	Total Revenues
Current Law	$2,416	$1,411	15.4%c/	$218
System 1: No exemptions, deductions, or tax credits. Capital gains taxed in full.	2,416	1,840	11.8	218
System 2: No personal exemptions, itemized deductions, or tax credits. Capital gains taxed in full. Standard deduction allowed.	2,416	1,390	15.7	218
System 3: No itemized deductions or tax credits. Capital gains taxed in full. Personal exemptions of $1,500 and standard deductions of $3,000 on a single return and $6,000 on a joint return allowed.	2,416	1,166	18.7	218

SOURCE: Systems 1 through 3 from EBRI calculations based on U.S. Congress, Congressional Budget Office, Revising the Individual Income Tax (Washington, D.C.: Government Printing Office, July 1983), pp. 55-58. Current law estimates from EBRI calculations based on IRS data.

a/ Personal income includes items like transfer payments and employer benefit contributions that would not be taxed under any of the systems in this table.
b/ Average rate on taxable income.
c/ This is not the tax rate actually in force in 1981, but rather the rate that would be required to yield this amount of revenue.

differing in their treatment of exemptions, deductions, capital gains, and tax credits. The current law example uses the existing tax structure. In each system, the tax rate is set to yield the same amount of revenue as would be paid under 1984 law at 1981 income levels. The only difference among the systems, therefore, is in the proportion of total income that is subject to tax and the average rate at which income is taxed. System 1, which eliminates

3/ Hypothetical systems drawn from U.S. Congress, Congressional Budget Office, Revising the Individual Income Tax (Washington, D.C.: Government Printing Office, July 1983), pp. 55-58.

virtually all tax preferences, carries the lowest average tax rate of 11.8 percent. System 3, which allows more liberal exemptions and deductions than current law, yields the smallest tax base and the highest average tax rate.

The chief advantage often cited for expanding the tax base and reducing marginal tax rates is to make the tax code more neutral in economic decisions. High marginal tax rates encourage taxpayers to seek out tax-favored sources of income--capital gains, for example--and tax-favored uses of income, such as housing. As a result, investment and other economic decisions are often driven by tax needs as much as by economic returns and productivity considerations.

The arguments for broadening the tax base have attracted a wide range of political support. Conservatives support base-broadening the tax base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. Liberals support broadening the tax base as a way of eliminating tax-code provisions perceived to benefit primarily the rich. At the same time, however, tax preferences were deliberately built into the tax code to further various social goals, among them enhancing the income security of employees. Many long-term economic decisions have therefore been predicated on the continued availability of these preferences, and many persons could find their economic well-being disrupted were these tax preferences no longer available.

PENDING LEGISLATIVE PROPOSALS

While many different tax structures can be designed, the two structures that have attracted the most attention in recent policy debates are the comprehensive income tax and the consumption tax.4/ The basic premise behind the comprehensive income tax is that individuals should be taxed on the value of what they produce, as represented by income. A comprehensive tax attempts to tax both actual and imputed income. Comprehensive income tax proposals include in taxable income not only cash wages but also all other items of value received by the employee as compensation.

The basic premise behind the consumption tax is that individuals should be taxed not on the economic value they generate but rather on what they use up--or the share of income that is not saved. The consumption tax would exclude all forms of saving from taxable income until the funds were used for consumption. The consumption tax would tax all employee benefits that do not result in saving. This includes various employee benefits that provide insurance protection, but does not include defined-benefit or defined-contribution pension plans, since they result in capital accumulation.

4/ Both tax systems require detailed judgments about the treatment of various sources and uses of income. Both would also create some formidable implementation and transition problems. These problems and issues are treated in detail elsewhere. For a discussion of employer pensions in basic tax reform, see Sophie Korczyk, The Tax Treatment of Pensions and Deferred Compensation (Washington, D.C.: EBRI, forthcoming). For a wide-ranging discussion of theoretical and practical issues in basic tax reform, see U.S. Department of the Treasury, Blueprints for Basic Tax Reform (Washington, D.C.: Government Printing Office, 1977).

Three recent legislative proposals provide examples of the comprehensive and consumption taxes. These proposals illustrate some of the tradeoffs in basic tax reform. All of them combine tax rate reduction with tax base expansion, with implications for most employee benefits.

Comprehensive Income Tax

Senator Bill Bradley (D-NJ) and Representative Richard Gephardt (D-MO) have introduced a comprehensive income tax proposal (S.1421/H.R.3271). It would raise the same amount of revenue as current law by using only a three bracket tax-rate structure: 14, 26, and 30 percent. The reduced rate structure would be financed by eliminating or cutting back approximately forty current-law tax preferences. Tax preferences that would be retained include deductions for home mortgage interest, charitable deductions, state and local property and income taxes, and some medical and business expenses. All employer-provided benefits, except for pension contributions, would be included in the employee's taxable income. The Section 415 limits on pension benefits and contributions would be made much more restrictive.

Senator Mark Hatfield (R-OR) has also introduced a comprehensive tax proposal (S.2158). Under this proposal, most deductions, credits, and exemptions would be repealed, and many items currently excluded from adjusted gross income would be included. The Hatfield proposal would retain current-law treatment for employer-provided pensions, but all other employer contributions for benefits would be included in taxable income. There would be six tax brackets, ranging from 6 percent to 20 percent. The current structure of exemptions and deductions would be replaced by five tax credits for the taxpayer, spouse, and dependents; and for portions of charitable contributions, home mortgage interest, taxes paid, and medical expenses.

Consumption Tax

Senator Dennis DeConcini (D-AZ) has introduced a consumption tax proposal (S.557). Under this proposal, all income other than that used for investment would be taxed at a marginal rate of 19 percent. This tax structure would be financed by eliminating nearly all current-law tax preferences. All income would be taxed once, and as close to the source as possible. Advocates of such a tax structure argue that it would eliminate the current situation which allows some income to escape taxation entirely, while other income is taxed more than once.

Contributions and benefits in retirement-income programs would retain their current tax-law treatment. The employer's contribution for health, welfare, and "fringe" benefits, however, would no longer be tax deductible as an employer compensation expense. Employees would not be taxed on the value of employer contributions for nonpension benefits since the employer would already have paid tax on these contributions. Since cash compensation would continue to be a tax-deductible cost of doing business to the employer, the employer would presumably have an incentive to offer more compensation in cash than in benefit contributions.5/

5/ This argument is advanced in Robert E. Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax (New York: McGraw-Hill Company, 1983), p. 90.

Comparing Major Proposals

All three legislative proposals, though they are based on different tax principles, would result in similar treatment for many benefits. Tax preferences for most employer-provided benefits would be eliminated. Employer contributions for nonpension benefits would be treated as taxable income. Had such a provision been in effect in 1982, an estimated $72.9 billion would have been added to that year's taxable employee compensation (Table 2). Federal tax revenues, as measured by the U.S. Treasury's calculations of tax expenditures attributable to these benefits, could have been as much as $19 billion higher, assuming current-law tax rates.6/

The primary differences among these proposals relate to their treatment of retirement income programs.7/ The DeConcini and Hatfield proposals would

TABLE 2

Employer Contributions and Treasury Department Tax Expenditure Estimates for Selected Voluntary Benefits a/ (in billions of dollars)

Benefit Contributions	Employer Cost b/ (1982)	Federal Tax Expenditures (1982)
Health insurance	$65.7	$16.4
Life insurance	7.2	2.0
Accident and disability insurance	NA	0.1
Other employer-provided benefits: child care educational aid legal services plans	NA	0.6

SOURCES: Employer cost data from table 6.15 in U.S. Department of Commerce, Survey of Current Business vol. 63, no. 7 (July 1983), p. 74. Tax expenditure data from Executive Office of the President, Office of Management and Budget, The Budget of the United States, Fiscal Year 1982, Special Analysis G.

a/ Voluntary benefits are those not mandated by law. Examples of mandatory benefits are Social Security benefits and unemployment compensation.
b/ Totals cover both private- and public-sector employees.

6/ Tax expenditure estimates are controversial. For discussions of the problems with tax expenditures, see EBRI's Issue Brief "Pension-Related Tax Benefits," no. 25 (December 1983) and Issue Brief "Employee Benefits and the 1985 Reagan Budget," no. 27 (February 1984). Current-law tax expenditures would overstate the revenue gains attributable to eliminating certain preferences under basic tax reform since marginal tax rates under the reform proposals would be lower.
7/ The DeConcini proposal would continue current-law treatment of interest on the savings component of whole life insurance, while Bradley-Gephardt would include such interest in taxable income. Most employer-provided life insurance is term life insurance, however, with no savings component. Such plans would thus not be affected.

continue the current-law treatment of pensions. Bradley-Gephardt would impose more restrictive benefit and contribution limits under Section 415 of the Internal Revenue Code. Limits on allowable benefits in defined-benefit plans would be reduced from $90,000 under current law to $60,000; contribution limits in defined-contribution plans would be lowered from $30,000 to $20,000; and indexing of these limits would be eliminated. The immediate effects of this change would be felt primarily by higher-paid persons. The longer-term repercussions could be much broader, however. As many as 10 percent of younger pension participants could be directly affected, and many more could be affected indirectly by the adjustments plan sponsors could be forced to make.8/

These proposals, therefore, would change the relative attractiveness of cash and benefits as forms of compensation. They would also change the relative attractiveness of various benefits. In general, tax policy under these proposals would continue to provide some encouragement for benefits that constitute capital accumulation, but benefits that provide current protection would be cut back.

IMPLICATIONS OF TAX REFORM FOR INCOME SECURITY GOALS

The elimination or restriction of tax incentives for employee benefits could reduce employees' economic security.

The tax system has stimulated the growth of employee benefits. Since the implementation of the income tax early in this century, statutory provisions excluding certain employer benefit contributions from taxable income have allowed and encouraged the development of employee benefits.9/ As a result, employees at all income levels now derive much of their economic security from employer-provided benefits. Pension, health, and life insurance benefit coverage in medium and large firms is already nearly universal.10/ Small firms, moreover, are not being left behind. Internal Revenue Service (IRS) data show, for example, that the average newly-qualified defined-benefit pension plan covers eighty employees, and the average new defined-contribution plan covers forty-five employees.11/

The growth of employee benefits has also been driven by macroeconomic conditions. While statutory tax rates fell at most income levels over the last twenty years, inflation nevertheless pushed taxpayers into higher tax brackets. Rising real tax rates on cash compensation encouraged the expansion of benefit coverage and the increased generosity of benefits. Employers and employees, seeking to halt the erosion of real compensation levels, steadily increased the share of compensation received in the form of employee benefits. Over the last twenty years, from 20 to 30 percent of the growth of employee

8/ For a full discussion of the long-term effects of changes in the Section 415 limits, see Korczyk, The Tax Treatment of Pensions and Deferred Compensation (forthcoming).
9/ See Why Tax Employee Benefits? (Washington, D.C.: EBRI, 1984).
10/ See U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms, 1982 (Washington, D.C.: Government Printing Office, 1983).
11/ EBRI calculations based on Internal Revenue Service, News Release, October 31, 1983.

benefits, as a share of compensation, can be attributed to this inflation-driven effect.12/

Employee benefits have now become an important element of the income security system. As much as a fifth of all spending on health care is now made through employer-sponsored plans.13/ Pension wealth, in turn, constitutes the main form of savings for more than half of all persons with pension coverage.14/

The expansion of employee benefits has primarily helped the middle income worker. Among employees with pension coverage in 1979, nearly 28 million (or 75.3 percent) earned less than $20,000 (Table 3). Among employed persons with employer-provided health coverage 58.3 million (or 79.8 percent) earned less than $20,000, and 19.1 percent earned between $20,000 and $50,000. Moderate-income employees would thus bear the brunt of any major tax-induced changes in employee benefit protection.

TABLE 3

Distribution of Employees with Pension and Health Coverage by Earnings

Earnings	Employees with Pension Coverage, 1979		Employees with Health Coverage, 1979	
	Total (in millions)	Percent	Total (in millions)	Percent
Less than $20,000	27.8	75.3	58.3	79.8
$20,000 to $49,999	8.7	23.7	13.9	19.1
$50,000 and over	0.3	0.9	0.8	1.1
Total a/	36.9	100.1	73.0	100.0

SOURCES: Pension distribution based on *Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement* (Washington, D.C.: EBRI, 1981). Health distribution from unpublished EBRI tabulation of U.S. Department of Commerce, Bureau of the Census, Current Population Survey (May 1980).

a/ Detail may not add to totals due to rounding.

12/ Korczyk, *The Tax Treatment of Pensions and Deferred Compensation* (forthcoming).
13/ Unpublished estimate, EBRI.
14/ See EBRI's *Issue Brief* "Pension-Related Tax Benefits," no. 25 (December 1983).

CONCLUSION

The tax-reform movement is fueled by strong discontent with current law. Most critics agree that the tax code is complex and sometimes provides perverse incentives.

Tax reform should be undertaken with caution, however. The tax structure's fundamental elements--the tax base and tax rates--are interdependent. A broadened tax base can allow a given amount of revenue to be collected at lower rates. Broadening the base, however, requires cutting back some current law tax preferences that were deliberately created to further certain social goals.

Basic tax reform proposals currently before the Congress would eliminate some of the incentives for employee benefits by including benefit contributions in taxable income. Many employee benefits would lose their attractiveness as a form of compensation if their value were fully included in taxable income, even if marginal tax rates were to drop considerably. Most employee benefits provide some form of hazard protection. Faced with a choice between a sure sum of taxable cash wages and an equal sum in taxable benefits whose usefulness depends on unknown risks, some persons would forego benefit protection. Those who guessed wrong about their needs for health or other forms of insurance would impose costs on society. These costs can be high. For example, recent proposals to provide health insurance for the unemployed--who represent only a small segment of the labor force--would have cost the federal government close to $2 billion annually.

Basic tax reform thus involves both benefits and costs for the business community, the federal government, and workers. Lower marginal tax rates could increase income-earning incentives, and a simpler tax code would be less intrusive in investment decisions. At the same time, however, basic tax reform proposals currently pending in Congress would require employers and employees to rethink the entire basis of compensation. In the course of this restructuring, lower- and middle-income workers would be likely to lose their access to employee benefits. This could result in sacrificing the achievement of social goals that are just as important as basic tax reform. Public debates over tax reform should reflect all these considerations.

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